RMDZ LOAN PROGRAM WORKSHOP
SUPPLEMENTAL INFORMATION

The following background information is provided as a basis for discussion at the RMDZ Loan Program Workshop.

I. MARKET DEVELOPMENT GOALS IN THE LENDING PROCESS

What is the purpose of the RMDZ Loan Program?

The program is a market development and diversion tool which assists local governments in achieving the diversion goals of AB 939. This is accomplished by providing a below-market rate and long-term financing to businesses that produce a recycled content, value-added product, or otherwise increase demand for materials that are normally disposed in a sanitary landfill.

How does "market development" differ from "economic development?"

While market and economic development create jobs and expand the local tax base, they differ in their focus. Market development encourages the creation or expansion of markets for recycled/recovered materials with the goal of diverting the maximum amount of material from the landfills. The emphasis is placed on companies that display the ability to effect a permanent increase in the annual consumption of secondary materials, thus a real affect on AB 939 goals. Economic development focuses on the creation of jobs and increasing the local economic base as its primary function.

II. RMDZ LOAN PROCESS

The following is a brief description of the loan process:

- Board staff works in cooperation with the local zone administrator to evaluate the eligibility and creditworthiness of a potential loan applicant based on limited information.

- If the business <u>appears</u> eligible and creditworthy, staff conducts an initial interview with the business.

  The initial interview determines:

  - <u>Borrower eligibility</u>. Who is the borrower and are they eligible for RMDZ financing?

  - <u>Eligible use of proceeds.</u> Are the sources and uses of funds appropriate?

  - <u>Project eligibility</u>. Does it meet RMDZ and Board goals and objectives?

> Initial character and credit assessment of the entrepreneur. What is the ability and willingness of the borrower to repay debt?

- Based on the initial interview, staff encourages businesses to apply for an RMDZ Loan if they have a reasonable likelihood of being approved.

- Applications are accepted each quarter. Staff reviews the project/company information provided to determine eligibility and to identify any deficient information. Staff notifies the loan applicant of RMDZ eligibility and requests deficient information.

- A complete analysis of eligible applications is performed by staff. Staff negotiates with each applicant the terms and conditions under which they will recommend approval of the loan request. Creditworthy applicants that demonstrate an ability to repay the proposed loan, and have agreed to the proposed loan terms and conditions, are recommended by staff to the Loan Committee for approval.

- Staff reviews the market development and diversion impact of each proposed project and assigns a numerical score based upon the Board's adopted priorities. In the event there is limited funding, loans are ranked based on this score.

- The Loan Committee meets each quarter to consider loan requests that are recommended by staff. The Loan Committee reviews staff's analysis and loan recommendations to consider the creditworthiness of each project. The Loan Committee may either recommend approval as presented by staff, approve staff's recommendation with modifications, or deny the loan request. The Loan Committee recommends creditworthy loan requests to the Market Development Committee for approval.

- The Market Development Committee considers loan requests recommended by the Loan Committee for final recommendation to the full Board.

- The Board reviews the Market Development Committee's recommendations and decides whether to approve loan requests.

- Approved loans are closed within 90 days of Board approval, unless extended by staff for an additional 90 days. If a loan does not close within 180 days of Board approval, the Board's commitment may be withdrawn.

III. CREDIT UNDERWRITING

Background

The best external validation of the RMDZ underwriting criteria occurred in June 1996, when the Board conducted the first sale of portfolio loans. As a pilot program, the Board sold 17 RMDZ loans, without recourse, to the Community Reinvestment Fund. The net proceeds of the sale amounted to $4.7 million dollars that is now available to lend eligible businesses. The Board may sell loans in the future if there is sufficient loan demand.

The underwriting requirements (cash flow, collateral and guaranty standards) affect the price offered for the loans on the resale market. The discount taken for a purchased loan is based upon the underwriting, collateral and guaranty criteria. The Board placed a total discount cap of 25% on RMDZ loans that are sold. RMDZ loans will garner a higher risk rating if underwriting criteria are not maintained to current commercial lending standards. The higher risk rating will result in deeper discounts and thus, less net cash back to the program for lending. The higher risk rating will also eliminate some loans for sale consideration in the secondary money market.

A. RMDZ Underwriting Criteria

All commercial loan officers have a fiduciary responsibility to the organization which they are employed. The RMDZ loan officers have a fiduciary responsibility to the tax payers of the State of California. That responsibility, delineated in statute, compels staff to recommend approval of only those loan applications that demonstrate the applicant's ability to repay the loan. To satisfy that requirement, every affirmative credit recommendation must have at least two out of three clearly identified sources of repayment based on accepted industry standards. Those sources of repayment come from the following categories:

1. **Primary** source of repayment is from current and/or projected cash flow of the existing business operations (a start-up business will only have projections to estimate repayment ability and thus, a start-up business can not demonstrate a primary source of debt repayment);

2. **Secondary** source of repayment is from the liquidation of business assets (e.g., equipment, real estate, accounts receivable, inventory) taken as collateral for the loan; and

3. **Tertiary** source of repayment is from the liquidation of non-business assets used to guaranty the loan such as: real estate (owner's personal residence), or a certificate of deposit. Personal guarantees can be from the owner(s) of the business or third parties. Guaranties can either be secured by pledging specific assets or unsecured.

B. Primary Source of Repayment Ability

The commercial loan officer draws on years of formal credit training and practical experience to determine the credit worthiness of an applicant. During the analysis process, the loan officer will seek answers to many questions that relate to the borrower's ability to retire the proposed debt. Factors that are considered include:

1. Ability to Pay: Does the company generate enough cash flow under the current business operation to support the projected loan payment along with existing debt service requirements? Is the permanent working capital sufficient to cover the increase in working capital needs due to the new project and ensure the continued operation of the business?

2. Willingness to Pay: Does the business credit report reflect a history of paying current creditors on time? Is the accounts payable turnover rate acceptable when compared to the industry standard?

3. Stability: How long has the company been in business? Normally, companies in business less than three years are considered start-up or new businesses. Start-up businesses cannot provide an operating history to a lender that proves the ability to operate at a profit. The lack of an established operating history (stability) coupled with a high failure rate for start-up business means that start-up businesses cannot provide the lender a reliable primary source of repayment ability. Therefore, the lender must rely on the quality of the secondary and tertiary sources of repayment.

4. Character of the business owner(s): Does the business owner have the experience, education and capability to handle a project of the type and size being proposed? Does the owner have the business acumen to anticipate, understand and solve company problems? Does the business owner have the character and resolve to repay the loan if unforeseen problems develop?

The character analysis is a subjective and instinctive exercise. A positive assessment of the business owner's character, and a financial analysis which shows the business can repay the proposed loan, provides a foundation for a positive lending decision.

The above questions will be answered during the detailed analysis of the company's financial statements and supporting tax returns, interviews with the business owner(s), and through observations by the loan officer.

C. Secondary Source of Repayment Ability

Once the loan officer has determined that historical and/or projected cash flow from the business is sufficient to cover the existing and proposed debt, and all other credit factors are favorable, the loan officer must then find a secondary source of repayment for the RMDZ loan.

Collateralizing the RMDZ loan with business assets is the most common method of satisfying secondary repayment requirements. The total discounted value of assets taken as collateral must be equal to or greater than the disbursed loan amount.

1. Historical Collateral Guidelines: Business assets are discounted for collateral purposes to account for the anticipated value the assets will generate upon liquidation. The values a lender receives for assets sold in a liquidation sale often is far less than the book value or fair market value, and often approach "fire sale" values. While each business is unique, a review of the current RMDZ loan portfolio resulted in the following average liquidation values:

Types of Security	Liquidation Value
New machinery and equipment	50% of cost
Used machinery and equipment	30% of cost
Accounts Receivable	80% of balance
Inventory	30%
Single family residence	80%
Cash and letters of credit	100%
Commercial real estate	60% - 70%

2. Historical Collateral Ratios: As stated above, lenders must collateralize a loan with assets at a discounted value in an amount equal to or greater than the disbursed loan amount. Staff surveyed several commercial lenders and established a collateral to loan ratio range from 1:1 to 2:1 for existing businesses and higher for start-ups.

A review of the current RMDZ portfolio revealed a collateral-to-loan ratio of 1.86:1 for established companies with at least three years in business and historical cash flow to support the existing and new debt. The portfolio ratio for start up companies with less than three years of operating history, and companies relying solely on projections to repay the RMDZ loan, have collateral-to-loan ratios of 1.64:1. Thus, on average $1.64-1.86 of discounted business and personal assets is collateral for every RMDZ dollar. It should be noted that the RMDZ Loan Program often subordinates its interest in the pledged asset to the participating bank. The Board is sometimes in a second or third lien position on collateral pledged to secure the RMDZ loan. Many banks do not give a collateral value to some assets that have existing liens. In this respect, the Board's collateral requirements are much more liberal than a commercial bank. The Board's willingness to subordinate creates higher foreclosure costs because of the need to satisfy superior lien holders. Thus, while the ratios show adequate collateral coverage, the net proceeds to the program may be lower.

D. Tertiary Source of Repayment Ability

The final phase of the credit analysis is the determination of tertiary sources of repayment for the RMDZ loan. Tertiary sources of repayment are usually non-business assets and/or guaranties used to secure the loan. Typically, the owner/operator of the business provides additional security for the loan by personally guaranteeing the loan. A guaranty is a promise to repay the loan independent of the obligation of the business to repay the loan. Personal guarantees can be from the owner(s) of the business or third parties. Guaranties can either be secured by pledging specific assets (real estate, owners personal residence, certificate of deposits) or unsecured.

1. Loan Guaranties: Staff surveyed several private and public lenders and verified that standard industry practice requires guaranties from those individuals or entities that control over 10%-20% of a partnership (not including limited partners) or corporations, including affiliated businesses. A guaranty is not required from a sole proprietor since the loan is made directly to the proprietor, and the proprietor is responsible for payment of the loan if the business defaults.

Personal guarantees are required of majority owners, especially in privately held companies, because owners are responsible for the day-to-day financial management of the business.

A personal guarantee by the partner or shareholder of a closely held business reflects commitment of the owner(s) to the general success of the business endeavor. The guarantor will be adverse to losing personal assets in case of foreclosure.

Guarantors will be willing to take an active part in the liquidation of the company's assets if foreclosure or default does occur. This active participation in the sale of pledged assets can yield higher liquidation values with less out of pocket administrative costs to the Board.

2. Types of Guarantees: A guaranty is an agreement between the lender and the guarantor under which the guarantor promises to repay the loan independent of the repayment obligation of the business. An unsecured guaranty is a promise from the guarantor to repay the loan with any or all assets of the guarantor. A secured guaranty is an agreement between the lender and the guarantor to provide certain assets as collateral for the loan, and repay the loan with any or all other assets of the guarantor. The specific assets identified in the secured guaranty add to the collateral offered by the business for the loan. The need to require a secured guaranty is based on the credit analysis and strength of the collateral being offered.

IV. LOAN PROGRAM OPTIONS

A. Start-up business

1. RMDZ Program Option: The Board could designate RMDZ Loan Program funds specifically to financing eligible start-up businesses

2. Definition of a Start-up Business: The lending community defines businesses as start-ups if they have a verifiable operating history of less than three years. The term "start-up" may also apply to an existing business that has changed ownership, or experienced other significant operating changes within the last three years. Using this definition, the Board has financed 19 start-up businesses through the RMDZ Loan Program. That represents 37% of the Boards 52 RMDZ loans. Of the 19 start-up loans made, seven are currently on the Loan Program's "watch list." The "watch list" contains loans that for one reason or another are in jeopardy of not repaying their loan as agreed. In total there are 11 loans on the "watch list," so start-up businesses represent 64% of the Program's troubled loans.

3. Significant issues in lending to start-up businesses: SB 1535, the RMDZ Loan Program legislation requires that:

"The Board shall approve only those loan applications that demonstrate the applicant's ability to repay the loan."

To determine an applicant's ability to repay the loan, staff must perform a detailed credit analysis of the loan request. The credit analysis is based upon the historical financial information provided by the business. Typically, three years of Profit and Loss Records, Balance Sheet Statements and Tax Returns are used to evaluate management's ability to operate the company. A start-up company does not have a historical track record, or has a very short one, to evaluate. Therefore, it is necessary for the loan officer to evaluate the company's projections.

The loan officer visits the business to observe operations and assess the business acumen of the owner. Part of the credit decision is based on the observations of loan staff during these site visits. Because many starts-ups are not operational during the underwriting process, the loan officer lacks critical information about the business and its owners.

With start-up businesses, analysis and the ability to predict repayment is severely limited. According to the National Development Council 95% of all start-ups fail within the first five years. Given the high failure rate and difficulty in analyzing the business owner's ability, making commercial loans to business start-ups is very risky. If the failure rate is 95%, then the loan program is getting five cents of diversion for each dollar risked on start-up businesses.

Most start-ups are organized as a sole-proprietor and are typically financed through owner injection and/or entrepreneurial means (loans from family and friends which don't require monthly debt service). Most lender's believe there is a direct correlation between the amount of leverage and the survival rate of start-ups. The higher the leverage, the lower the survival rate. Thus, an entrepreneur and lender should be cautious when considering a commercial loan for a start-up business.

Funding for start-up businesses could be targeted at companies that are introducing new technology. Capitalizing a start-up, which uses new technology, with debt should take into consideration the length of time it takes for the new technology to become economically feasible. There is usually a long period of low productivity and high expenses. Companies with a heavy debt capital structure generally do not survive this implementation stage.

Below is a summary chart comparing underwriting considerations between established and start-up businesses:

ISSUE	ESTABLISHED BUSINESS	START-UP BUSINESS	MITIGATING FACTORS
MANAGEMENT CAPABILITY, can the company's management operate the business to generate profits/cash flow and control assets?	Operating statements (profit and loss & balance sheet), suggest managements' expertise in operating this business. Site visits and visual inspection of business.	No operating statements to use for analysis. Frequently there is no existing site to inspect.	Experience managing a similar business. RESUME.
PRIMARY SOURCE OF REPAYMENT Operating cash flow to service debt and cover permanent working capital needs and supply owners' living expenses.	Historical cash flow of the business evidenced by 3 years of financial statements. CF>DS+PWC+OLE[1]	No operating statements, so primary source of repayment cannot be established for start-ups.	A business plan and projections prepared by the owners.
SECONDARY SOURCE OF REPAYMENT	Existing and acquired business assets.	Business assets purchased or contributed to start Business	Liquidation value of collateral sufficient to repay loan
TERTIARY SOURCE OF REPAYMENT	Personal or third party guarantees, un-pledged assets, other income.	Personal or third party guarantees, un-pledged assets, other income.	Family or debt repayment can be supported by outside sources.
COMMERCIAL CREDIT HISTORY	Dunn & Bradstreet report, TRW, query vendors. Personal credit report.	Personal credit report.	Clear personal credit history

4. <u>Program credit requirements for lending to start-ups</u>: To comply with RMDZ statutes the Loan Program has been lending to start-up businesses using the following guidelines:

a. Owner must have business management experience, preferably in the same industry, and strong technical knowledge in the field;

[1] CF = profit after tax + depreciation and non-cash expenses, DS = principle portion of debt service, PWC = increase in permanent working capital needed, OLE = draw owner needs to support personal living expenses.

b. Leverage should be minimal, and at least 50% of the start-up costs should be injected by the owner in cash or from sources that don't require debt service or encumber assets;

c. Owner must have a clear personal credit history;

d. Collateral requirements for start-ups should be significantly higher than for an existing business, a minimum collateral coverage ratio of 2:1 should be considered.(95% of the time the lender will be liquidating assets to repay the loans to start-ups); and

e. Lender/borrower relationship should be positive. Every time an RMDZ Loan is funded, the Board is entering a long-term relationship with the borrower. If borrowers are deceptive during the underwriting stages of the loan process, there is high potential for problems with the borrower during the term of the loan.

5. Potential strategies: The Board could continue to fund start-ups that demonstrate the ability to repay the loan. Each loan application is evaluated on its own merit, and if eligible and credit worthy, the loan is approved.

The Board could limit the amount of RMDZ loan funds available to start-up businesses each year. For example, the Board may establish a goal of no more than 20% of the RMDZ Loan portfolio may be comprised of start-up businesses.

The Board could seek legislative authority to designate RMDZ Loan Program funds specifically to financing eligible start-up businesses that do not meet current underwriting standards.

B. Microloan program

1. RMDZ Program Option: The Board may establish an element in the RMDZ Loan Program that designates funds specifically for lending to "microenterprises."

2. Definition of a microenterprise: Microenterprises are typically, businesses that have five or fewer employees, including the owner. Many of these businesses are home based and are start-ups. Microloans are small commercial loans, usually granted to microenterprises and range from $500 to $20,000. These businesses are not considered creditworthy by most commercial lenders because they have minimal collateral and lack an operating history.

In the October 1996 edition of the *Christian Science Monitor*, Electronic Edition:

"Last year 3.5 million new businesses were started in the U.S., according to a recently released survey conducted by the Gallup Organization for Wells Fargo Bank and the National Federation of Independent Business...most of the new businesses are very small. Fewer than half list a business telephone. Two-thirds effectively employ the home as their principal business location...these businesses amount to less than 1 percent of U.S. economic output."

At a recent statewide conference on lending, it was clear that microloan programs have become a popular economic development tool generally focused on specific social objectives and job creation within targeted disadvantaged groups (economically disadvantaged, welfare recipients, displaced workers, etc.). Because of a recognized failure rate over 95%, most microloan programs are a single component of an established entrepreneurial training and personal development program. Many microloan programs require participation in ongoing entrepreneurial training and staff mentoring as a condition of granting the loan. Economic development practitioners attempt to mitigate the failure rate associated with microenterprises by requiring the owner's participation in a comprehensive business development program. Loans provided to microenterprises without business training and mentoring increases the likelihood of failure. Business failures often represent a tragedy for the individual and their families.

The RMDZ Loan Program has no established minimum loan request. However, because of program design and cost constraints the smallest loan approved and funded has been $29,600.

3. Significant issues lending to Microenterprises:

Most businesses seeking microloans are not eligible under current RMDZ statutes. RMDZ loan program statutes require that loan applicants demonstrate the ability to repay the loan. To comply with program statutes, the loan officer must verify the microenterprise satisfies minimum credit underwriting criteria (must have two sources of repayment see Section III). Microloans, almost by definition, are primarily intended for businesses that are not creditworthy and lack sufficient collateral to secure a conventional loan. Thus, without statutory changes, most microenterprises are ineligible for an RMDZ Loan.

Microloan financing options are available to microenterprises. Most banks will provide conventional or government supported financing (SBA, CalCAP, CDBG, etc.) to creditworthy borrowers requesting loans under $100,000. The California Association for Local Economic Development (CALED) has identified over 100 local small business revolving loan funds (RLF) in California. Small loans through private lenders or a local RLF may require less documentation and are thus, less difficult for the borrower to obtain than RMDZ financing.

RMDZ staff lack the resources to provide entrepreneurial training and technical assistance to potential borrowers. Successful microloan programs are part of a comprehensive entrepreneurial development program, which includes extensive business training before funding and ongoing technical, legal, accounting and marketing assistance. The RMDZ Program lacks the infrastructure and staffing to support a comprehensive business development program.

Microlending would redirect RMDZ staff resources. Microenterprises have a historical failure rate over 95%. Due to the high failure rate, loans to these businesses may result in the need for the Board to foreclose on most of the borrowers. Dealing with problem loans, foreclosure and liquidating assets are staff intensive activities. If a microloan component was established, staff resources would need to be redirected to deal with a potentially high volume of non-performing loans.

Microloans would be expensive for the Board to originate and close in comparison to the amount of the loan. Loan origination and closing costs on microloans could exceed the amount being funded (a $500 loan would cost more to originate and close than the value of the loan). Currently, closing costs usually exceed $3,000 per RMDZ loan. This does not include staff time to process and underwrite the loan application. The Board must verify program requirements are fulfilled, evaluate the financial viability of the company, and execute loan documentation to secure the State's interests. As a public entity, even if a streamlined RMDZ Loan process for microloans were established, the Board's loan origination and closing costs would be very expensive in relation to the amount of the loan.

An RMDZ microloan program could divert scarce local resources from more productive RMDZ Program activities. Most of the zones lack sufficient resources to market and operate the RMDZ program locally. Less than five zones have staff dedicated full-time to the RMDZ program. Most zones have staff positions dedicated one-quarter time or less for the program. If the Board initiates a microloan program, considerable interaction between borrowers, Zone Administrators, and Loan Program staff would be required. This activity would divert scarce local resources away from the RMDZ projects that may better meet program diversion and market objectives. Adoption of a microloan program could direct resources away from local marketing efforts.

4. Potential strategies: The adoption of a microloan program would require major modifications to the existing loan program. The Board must seek legislative authority to lower credit underwriting standards. Additional staff would be needed to operate the RMDZ microlending program that would result in higher administrative costs.

The Board may also take a different approach and grant funds to assist microenterprise development. Grant funds would be available to entities that have or can develop specific resources to undertake a comprehensive microenterprise development program. The Board needs legislative authority to grant RMDZ Loan funds.

3. <u>The California Capital Access Program (CalCAP)</u>. CalCAP provides access to capital for "near bankable" businesses that carry a higher risk than conventional lending standards (start-ups, highly leveraged companies, uncertainty regarding collateral, very small businesses, etc.). The rates, terms, collateral, and conditions are determined by a participating bank. A fee of 2%-31/2% is paid by both the borrower and the bank. The combined 4%-7% is then matched by CalCAP and deposited into a loss reserve fund for the individual bank. Losses by individual banks can be offset by the amount in the CalCAP loss reserve.

b. Would not be accepted or used by banks that already utilize several major guaranty programs. Even if the program would gain a level of acceptance, it would require several years for this to occur and the program has a sunset date of 2006;

c. Would not achieve any additional leveraging of RMDZ funds. Due to the lack of a program track record most banks would require 100% fund reserve; and

d. May require administrative overhead costs equal to or greater than direct lending.

For these reasons, the Board is considering participation, on a pilot basis, in the CalCAP loan guarantee program instead of establishing its own RMDZ guaranty program.

4. <u>Potential strategies:</u> Since 1994, the Board has considered several agenda items and heard testimony supporting the idea of Board participation in the California Capital Access Program (CalCAP). In its May 1995, RMDZ Loan Program Evaluation Report to the Legislature, the Board recommended participation in CalCAP on a pilot basis for an amount not to exceed $500,000. The Board received statutory authority to participate in CalCAP with the passage of SB-1535 (Killea) in 1996.

Consistent with the desire of the Administration and the Legislature not to duplicate existing state programs, the Board's participation in CalCAP could be an efficient and effective tool to provide access to capital for small and start-up businesses. After only 2 1/2 years, the 37 participating banks have made 1,340 loans totaling $184 million creating nearly 6,700 jobs, and representing a 23.4:1 leverage ratio of CalCAP contributions. Staff estimates that if the Board were to participate in CalCAP, a $500,000 investment would result in over $12 million in capital for recycling businesses that otherwise might not have access to financing.

Upon direction by the Board, staff and the California Pollution Control Financing Authority (CPCFA) would develop the memorandum of understanding for participation in the program. Participation, eligibility criteria, and the internal approval process would be detailed in a Board agenda item (the program already exists in CPCFA regulations). If approved, the Board's participation in CalCap could occur by summer 1997. Due to the streamlined process for approving CalCAP loans, the impact on Board staff resources should be small.

NOTE: The information provided in this document is intended for background information and is not an exhaustive discussion of these issues. If you have questions about this material, please contact Mr. Fran Aguilera at (916) 255-2498 or Mr. Robert Caputi at (916) 255-2442.